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Supreme Court of the United States

OCTOBER TERM, 1940.

No. 343

In the Matter

of

WISE SHOE COMPANY, INC.,
Debtor.

MOHONK REALTY CORPORATION,
Petitioner-Appellant,

WISE SHOE STORES, INC.,
Appellee.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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MOHONK REALTY CORPORATION, petitioner-appellant, respectfully prays that a writ of certiorari be issued to review the judgment of the United States Circuit Court of Appeals for the Second Circuit entered in the above cause on the 3rd day of May, 1940, affirming an order of the United States District Court for the Southern District of New York, denying the motion of petitioner (a) to vacate and set aside a certain decree of the District Court, which consummated a plan of reorganization and discharged the above named debtor of its liabilities; (b) to amend the said plan of reorganization to the extent of requiring all unexpired leases of the said debtor, which were not rejected in the reorganization proceeding, to be assumed by Wise Shoe Stores, Inc., the reorganized company (hereinafter called appellee).

Opinions Below.

The opinion of the District Court is to be found at (R. 235). It has not been reported. The opinion of the Circuit Court of Appeals (pp. 88-93) is reported in 111 F. (2nd) 287.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on May 3, 1940. An application for an extension of time within which to file the petition for certiorari until August 16, 1940, was granted by Mr. Justice Reed on August 2, 1940. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (28 U. S. C. A. 347).

Questions Presented.

1. Whether a plan of reorganization filed in a proceeding under (former) Section 77-B of the Bankruptcy Act, by a Creditors' Committee, which failed to make provision for the assumption by the reorganized corporation of the unexpired leases which had not been rejected, and which plan did not on its face disclose that it was not intended to have the reorganized corporation assume such leases, is not, as a matter of law, a fraud upon the landlords affected and an invalid plan within the purview of the statute mentioned.

2. Whether, when such an invalid plan of reorganization is confirmed by the District Court in ignorance of the fact that it contemplated a transfer of all unrejected leases to the reorganized company without any obligation on the part of the latter to assume the same, the landlords affected are not entitled, upon discovering the true facts (a) to the absolute right of having the case reopened and the reorganization plan amended to impose upon the reorganized company the duty to assume the un-

rejected leases, or (b) at least to a claim for damages equal to what they would have been entitled to prove for had their leases been rejected before confirmation of the plan.

3. Whether the appropriation by members of a Creditors' Committee for themselves personally and for other members of their class, of all the assets in which other creditors too have a common interest, through the medium of a reorganization plan under Section 77-B, is not such a fraud in law as to entitle the excluded class of creditors, upon discovery of the fraud, to the absolute right of reopening the case and obtaining appropriate relief.

Statute Involved.

Former Section 77-B is involved in this proceeding, particularly the following subdivisions thereof:

Section 77-B (b) (10) (11 U. S. C. A. 207 [b] 10):

"* * * The term 'creditors' shall include for all purposes of this section and of the reorganization plan, its acceptance and confirmation, all holders of claims of whatever character against the debtor or its property, including claims under executory contracts whether or not such claims would otherwise constitute provable claims under this Act. * * *"

Section 77-B (f) (1) (11 U. S. C. A. 207 [f] 1):

"After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, * * *."

Section 77-B (f) (7) (11 U. S. C. A. 207 [f] 7):

"Before or after a plan is confirmed, changes and modifications may be proposed therein by any party in interest and may be made with the approval of the judge after hearing upon notice to creditors and stockholders, * * *."

Statement.

Petitioner, on August 18, 1936, leased its premises, known as 11 West 34th Street, New York City, to the debtor, Wise Shoe Company, Inc., for a term beginning November 1, 1936 and ending December 31, 1946, at a rental of $44,000 per annum up to October 31, 1941 and $48,000 per annum for the balance of the term (R. 86).

The debtor was in occupation of these premises and others when it filed its petition for reorganization in the Southern District of New York on August 19, 1938. On that date, Judge Patterson approved the said petition and signed an order continuing the debtor in possession (R. 7). Even before the filing of the said reorganization petition, a so-called Creditors' Advisory Committee had been formed consisting of ten of the largest merchandise creditors (R. 20-21) and representing in excess of 66⅔% in amount of the unsecured claims (R. 11). This Committee retained accountants, attorneys and a secretary and throughout the entire reorganization proceeding took a most active part in the case (R. 21, 47, 62, 168, 219). Indeed, the counsel for this Committee completely dominated and controlled the course followed by the debtor in possession throughout the entire period of the reorganization. Although the Committee was composed solely of merchandise creditors, it did not label itself as a Merchandise Creditors' Committee, but called itself a Creditors' Advisory Committee (R. 21). The attorneys for this Committee also called themselves attorneys for the Creditors' Advisory Committee (R. 47). Throughout the proceedings, the Creditors' Committee purported to act for all the creditors, while its attorneys applied for and received an allowance for their services rendered for all creditors. At no point in the proceedings did the Creditors' Committee or its counsel indicate that it was only

serving the merchandise group and that the landlords were expected to shift for themselves.

Immediately after the approval of the debtor's petition and the entry of the order continuing it in possession, this Creditors' Committee, acting through its counsel, took up with the officers and attorneys of the debtor, the question of retaining or disaffirming the various leases. The debtor was a chain store concern, selling women's shoes and hosiery at retail in its numerous stores. Naturally, the leases of these stores constituted one of its most important assets. In their desire to preserve such of the leases as they considered to be of value for the benefit of any reorganization that might be effected, counsel for the Committee proposed to the debtor that it obtain at once waivers from the various landlords whose leases the committee desired to retain, by which waivers the landlords would give up whatever rights they had under their leases to cancel such leases because of the filing of the reorganization petition by the debtor (R. 200-203). Petitioner was one of the landlords asked to grant this waiver and it did so (R. 177-179).

The debtor made efforts to reorganize, but found itself unable to do so. Finally, its stockholders stipulated that there was no equity in the assets for them (R. 40-41). In order to facilitate a reorganization by the creditors themselves, these stockholders turned over all of their stock to the Creditors' Committee (R. 15).

On October 25, 1938, the Creditors' Advisory Committee decided that the time was ripe to file a reorganization plan and did so. The only paragraph in this plan, dealing with the matter of the leases, is paragraph 5. It was headed "executory contracts" and reads as follows (R. 17-18):

> "All contracts of the Debtor which are executory in whole or in part, shall in nowise be affected by this Plan, except that the Debtor reserves the right

> to disaffirm such of its present outstanding leases as it may deem appropriate in the premises. The said notices of disaffirmances, however, shall be served upon the landlords affected prior to the date fixed for the confirmation of this Plan."

Obviously, the above mentioned proviso was in all respects proper and unobjectionable. It provided that any leases that were to be disaffirmed must be disaffirmed at least ten days prior to the time fixed for confirmation of the plan, thus affording landlords affected an opportunity to prove their claims for damages.

However, some time after this plan had been proposed by the creditors' committee, such committee—for reasons which only became apparent subsequently—decided to shelve it and present a so-called amended plan (R. 22-48).

The amended plan differed from the original plan only in respect of the treatment to be accorded the unsecured creditors and the landlords. Whereas the original plan gave the unsecured creditors an option to take 25% of the amounts of their claims either in cash or in capital stock of the reorganized company, the amended plan eliminated the cash option and required that all creditors take 25% of their claims in capital stock of the new corporation (R. 25, 26, 39).

With regard to the landlords, the amended plan, under the heading "Executory Contracts," contained the following provision (R. 41-42):

> 10. "The Debtor reserves the right to disaffirm all contracts, including unexpired leases, which are executory in whole or in part. The Debtor, however, shall serve such notices of disaffirmance or rejection upon the parties to said contracts or leases at least ten days prior to the date fixed for the hearing of the confirmation of this Plan."

The above paragraph followed a long-winded section numbered 3, containing nine paragraphs and headed

"Means for Execution of Plan." Tucked away in subdivision D of this Section 3, without any distinguishing marks or headings to direct attention to its important contents, there appeared the following sentence (R. 28-29):

> "The Debtor and/or the Debtor in Possession shall likewise assign to the New Corporation, all unexpired leases, except such as may be rejected by the Debtor."

It will be noted that this sentence neither said nor did not say that the assignment of the unrejected leases to the reorganized corporation was to be without assumption of liability. Considering the fact, however, that in Paragraph 10 of the amended plan dealing with Executory Contracts there was reserved to the debtor the right to disaffirm all unexpired leases, right up to ten days before the confirmation of the plan, it is, we submit, perfectly apparent that any landlord reading the plan, and, indeed, even a skilled and experienced lawyer examining it, would have gotten the impression that the plan contemplated that the debtor would either disaffirm the leases it regarded as undesirable and give the landlords their right to file a claim for damages, or else that the unrejected leases would be taken over and assumed by the reorganized company.

At all events, the attention of the District Court was not called to the fact that subdivision (d) of the amended plan (R. 28-29) had been deliberately introduced for the purpose of enabling the reorganized company to take over by assignment about thirty existing leases which had not been disaffirmed, without assuming any liability thereon and without giving the landlords affected any opportunity to file claims for damages when (as later happened) these unrejected leases assigned to the reorganized company were repudiated by the latter.

The merchandise creditors, who constituted the Creditors' Committee which proposed the amended reorganiza-

tion plan, were all manufacturers of either shoes or hosiery and greatly interested in keeping the business of the debtor corporation going so that they could continue to have an outlet for their products. Both the original and amended plans of reorganization contemplated a continuance of the business of the debtor corporation under the auspices and control of these merchandise creditors.

The two largest merchandise creditors in the case were J. A. Izenstatt and Philip W. Lown, who, between them, at the time of the reorganization, held claims totaling $133,741.55 out of total liabilities of approximately $420,000 (R. 146-147). These creditors were on the Creditors' Committee (R. 21, 72, 73). The counsel for the Creditors' Committee, Mr. Trachman and Mr. Mintz, were the personal attorneys of Izenstatt (fol. 155), and it was they who formulated and filed both the original reorganization plan and the amended plan (R. 21, 46, 47). By reason of events which occurred subsequently, but which were obviously planned in advance, Izenstatt and Lown became one-half owners of the reorganized business by buying out, with Mr. Schoen, President of the debtor corporation (now Vice-President of the appellee), and his relatives and friends, the capital stock received by the other creditors on the reorganization (R. 132-133). As one reviews these events, no one can doubt that the amended reorganization plan was deliberately framed as it was to permit these two merchandise creditors, who controlled the Committee, and Schoen, to later take over the assets and business of the debtor corporation free from any liability on the unrejected leases. The record contains abundant evidence to that effect (R. 155, 156; 164-167). First, efforts were made to obtain rent reductions deemed adequate by the Creditors' Committee from the various landlords holding the unrejected leases. All manner of pressure was brought on these landlords to force reductions. When landlords proved recalcitrant and the anticipated damage claims were not too large, the

leases were disaffirmed. Where, however, the resulting damages from disaffirmance were so large as to occasion a question whether the Creditors' Committee would be able to muster the necessary two-thirds in amount of the creditors' claims to obtain approval of its amended plan, the leases were not disaffirmed and the landlords were lulled into the belief that such leases would remain unaffected and would be taken over by the reorganized company. The record contains some rather unsavory recitals touching upon the methods employed by the Creditors' Committee and their counsel in an effort to force rent reductions (R. 156).

At all events, when the Creditors' Committee had exhausted its efforts upon the landlords holding the unrejected leases, steps were immediately taken to obtain confirmation of the amended plan which had then been pending in the Court for over two months. Copies of this plan were mailed to all the landlords, even those who, like the petitioner, had no provable claims which could then be asserted against the debtor. Nothing, however, was told such landlords either in the plan or in any accompanying letter or circular or in any other way that the unrejected leases were merely to be assigned to the reorganized company, but no liability thereunder assumed. When, therefore, the matter came before Judge Patterson for confirmation, none of the landlords holding the unrejected leases put in any appearance for the obvious reason that they did not consider that they had any interest or standing in the proceeding. Judge Patterson was not told that the amended plan, unlike the original plan, contemplated only an assignment of the unrejected leases without any assumption of liability by the corporation. Had he been so told, as he said later in his opinion, he would probably not have approved the plan (R. 245). At all events, no objection was urged against the plan and Judge Patterson approved it. There was thereupon transferred to the appellee, the reorganized com-

pany, all of the assets of the debtor corporation (R. 65-66), including all of the existing leases of the debtor which had not been disaffirmed (R. 66), including the petitioner's lease.

On June 30, 1939, the appellee, together with the debtor, applied to Judge Patterson for an order terminating the reorganization proceeding. They reported that the plan of reorganization had been fully consummated; that the assets of the debtor corporation had been turned over to the appellee; that the capital stock of the appellee had been issued to the creditors; and that "all acts required to be performed by the debtor for itself and as debtor in possession and by Wise Shoe Stores, Inc., to carry the Plan of Reorganization into effect have been completed and are terminated * * *" (R. 72). Upon this *ex parte* petition, Judge Patterson granted an order on June 30, 1939, terminating the reorganization proceeding and closing this case (R. 55-60). Included in this order was a provision discharging the debtor "from all of its debts, claims and liabilities" (R. 59) and restraining all creditors and claimants

> "from pursuing or attempting to pursue, or commencing any suits or other proceedings at law, in equity or otherwise, against Wise Shoe Stores, Inc., or any of the assets or property transferred by Wise Shoe Company, Inc., to said Wise Shoe Stores, Inc., directly or indirectly * * *" (fols. 59-60).

The debtor corporation throughout the whole period of its reorganization paid full rent to the landlords with the unrejected leases, so that, at the time of the hearing on the confirmation of the amended plan, none of such landlords was in a position to file a claim for damages based upon a disaffirmance or rejection of its lease, nor assert that it was a creditor with a perfectly provable claim.

After the confirmation of the amended plan, the appellee for a time continued to occupy the various prem-

ises covered by the unrejected leases and to pay the full rent due thereunder. After the order terminating the proceeding had been approved, however, and in the month of October, 1939, counsel representing the appellee approached the petitioner and stated that unless a reduction in rent regarded as suitable by the appellee was immediately granted, the appellee would move out (R. 97). When petitioner remonstrated that such removal could not be legally accomplished without subjecting the appellee to damages, the reply was made that under the amended reorganization plan which had been effected, the appellee had taken over the leases only by assignment and had assumed no liability whatever thereon, and that, therefore, the appellee could move out without subjecting itself to any damages (R. 98-99). The Fulton & Elm Leasing Co., another landlord, was given the same ultimatum (R. 167-168). These ultimatums were carried into effect and, soon after the reorganization had been completed, the reorganized company removed from petitioner's premises and completely repudiated petitioner's lease with the debtor. It did so on the theory that it was merely an assignee of the lease and that only privity of estate existed between it and the petitioner, which privity of estate was terminated when it removed from the premises.

An investigation by petitioner and other landlords then disclosed that the sponsors of the amended reorganization plan had in fact succeeded in obtaining approval of a plan which enabled the appellee to throw overboard all or any of the leases taken over by it with complete impunity on its part. By the time this discovery was made, petitioner, of course could no longer file any claim for damages in the reorganization proceeding or receive redress for the injuries which it was certain would be sustained upon the repudiation of its lease. There was, therefore, no course left open but to present the matter to Judge Patterson and to move before him for a reopening of the reorganization proceeding and for a modification of the decree ap-

proving the reorganization plan to the extent of requiring the appellee to assume all of the leases taken over by it which had not been previously disaffirmed, or for such other relief as the Court could grant (R. 79-83).

On the hearing before Judge Patterson, petitioner claimed that the plan or reorganization was inequitable and fraudulent as a matter of law, if not in fact, for failing to provide *pro rata* distribution of the assets of the debtor among all creditors on an equal footing. Petitioner also claimed that the Creditors' Committee and its counsel having purported to act for all creditors, owed, as a matter of common honesty and trust, the duty of disclosure to the Court that one class of creditors, viz.: landlords, were not being provided for. Petitioner urged that this duty should have been particularly observed in this case because the members of this Committee obviously stood to gain an advantage for themselves by excluding the landlords with the unrejected leases from participating with them in the reorganization and for the further reason that certain members of the Committee had joined with relatives and friends of the debtor's President to purchase all of the assets of the reorganized company, and that these assets were manifestly worth far more when acquired free from any obligation to landlords.

In opposition to petitioner's motion, the appellee offered no defense whatever based either upon the propriety or the fairness of the amended plan. Not the slightest attempt was made to defend the ambiguous and evasive language in subdivision (d), which gave the reorganized company the right to take over all of the assets, including the unrejected leases, without, however, assuming any liability upon these leases. The only defense appellee did offer before Judge Patterson was that a copy of the amended plan had been sent to all of the landlords, including the petitioner, and that they should have been alert and vigilant enough to detect from the language of subdivision (d) that the reorganized company was not

planning to assume any liability on the unrejected leases; also that if such landlords failed to understand or to detect the true meaning of subdivision (d), the fault was their own. The appellee argued further that the reorganization proceeding should not be re-opened for the reason that certain persons had invested new money in the business following the approval of the plan and that they would be prejudiced by the imposition of new liabilities upon the appellee.

Although it was shown that the so-called new investors in the appellee were Izenstatt and Lown (members of the Creditors' Committee), who between them contributed 50% of the new money, and relatives and friends of Mr. Schoen (the former President of the debtor corporation and now the Vice President of the appellee corporation), who between them contributed the remaining 50% (R. 130-133), and although it was also shown that the amount of assets which the appellee took over from the debtor corporation aggregated more than $500,000 in excess of the total liabilities of the debtor corporation (R. 49-54), whereas the total new capital alleged to have been contributed amounted to only $150,000 (R. 133), Judge Patterson denied the motion of petitioner to vacate the decree approving the amended re-organization plan upon the sole ground that it would be inequitable as against those who had invested the new money in the interval between the confirmation of the reorganization plan and the making of petitioner's motion to saddle new liabilities upon the appellee (R. 246). Judge Patterson did, however, state that the amended plan "was unfair to lessors and unduly favorable to general creditors in not requiring that the new company assume all liabilities of the debtor under the leases to be assigned" (R. 245). He further said that if petitioner had made seasonable objection, such objection would probably have been sustained and the plan amended or modified accordingly (R. 245).

Petitioner took an appeal to the Circuit Court of Appeals for the Second Circuit from this decision of Judge Patterson, and that Court, in a decision written by Judge Clark, affirmed the ruling of the lower court (pp. 88-93). Judge Clark seemed to base his decision upon the ground that the petitioner's application to re-open was addressed to the discretion of the District Court and that there was no abuse of discretion on the part of Judge Patterson in refusing to reopen (p. 90).

We express the hope that this Court will not dispose of our application on the theory that it presents nothing more than an attempt to obtain a review of a motion involving a mere exercise of discretion by the District Court. A fair reading of the papers will, we believe, satisfy this Court that our application involves far more than that. It deals with nothing less than the preservation of honesty and fairness in reorganizations carried on in the federal courts. Furthermore, it presents squarely the issue whether creditors' committees which attempt such reorganizations on their own behalf are to be permitted, by sharp dealing or other objectionable methods, to obtain approval of reorganization plans which give them the assets and leave empty-handed landlords with unrejected long term leases.

Specifications of Errors to be Urged.

The Court below erred

(1) in affirming the order of the District Court;

(2) in failing to hold that the amended plan of reorganization, which Judge Patterson approved without knowing that it made no provision for the landlords holding unrejected leases, was fraudulent as a matter of law and entitled petitioner upon discovering the true facts to have the case reopened and the reorganization plan modified, so as to make the same provision for landlords as was made for other creditors;

(3) in holding that the petitioner and other landlords with unrejected leases were bound by the reorganization plan, simply because a copy thereof was sent to them in the mail, even though this plan made no provision for them and did not fully and fairly apprise them that their leases could be later disaffirmed without liability on the part of the reorganized company;

(4) in holding that the plan itself contained a notice of rejection or operated as a rejection of petitioner's lease and thus conferred upon petitioner the status of a creditor with a provable claim entitling it to be heard in opposition to the plan;

(5) in failing to hold that this case falls within the doctrine of *Kansas City Railway* v. *Guardian Trust Co.*, 240 U. S. 166, where this Court held that a plan of reorganization, which did not on its face give notice of an intent to prefer a certain group of security holders over others having a paramount position by law, was not binding on the latter, even though they assented to the plan;

(6) in failing to grant petitioner relief at least to the extent of vacating the stay contained in the order of June 30, 1939 (R. 55-60) enjoining petitioner from commencing any suit against the debtor or from following any of its assets into the possession of the reorganized company;

(7) in holding that the question involved herein was merely one of discretion and also in holding that there was no abuse of discretion in denying petitioner's motion to reopen the reorganization proceeding;

(8) in failing to hold that the Creditors' Committee, which framed and obtained approval of the reorganization plan in this case, had no right to utilize its position of trust for the purpose of obtaining an unfair advantage for its members and the other creditors at the expense of landlords.

Reasons for Granting the Writ.

This is the first case which we have been able to find since the enactment of Section 77-B of the Bankruptcy Act where a reorganization plan was deliberately framed to permit one group of creditors to take over the business of the debtor corporation and continue it for their benefit, free from any liability to landlords who held unrejected leases. A similar scheme was attempted under the old-fashioned equity receivership practice which prevailed prior to Section 77-B, in the case of *Howard* v. *Maxwell Motor Car Co.*, 269 Fed. 292, affirmed 275 Fed. 52. There the scheme was strongly condemned by the Second Circuit Court of Appeals and the landlord affected was left free to pursue his common law remedies and to follow the assets of the debtor corporation into the hands of the reorganized company. Manifestly, the questions presented by this application are of such far reaching importance in the field of reorganization law, that they transcend in importance the immediate issues in this case. If the decision below is allowed to stand, it will furnish a most dangerous precedent whereby sponsors of reorganization plans, by the use of adroit and equivocal language in the plans, can manoeuver landlords and other classes of creditors into a position where they are deprived of all opportunity to participate in the avails of the reorganization.

The fundamental question which permeates this entire case is whether a reorganization of an insolvent corporation under Section 77-B or under the successor statutes is to be permitted, by which a certain group of creditors take over all of the assets and the benefits which go with those assets, without assuming the burden of the contracts and leases which have not been rejected in the reorganization. Stated in another form, this question is whether the processes of the District Courts are to be permitted to be invoked not for the purpose of enforcing

or protecting the rights of all creditors, but merely to defeat the rights of certain of such creditors.

We will deal now with the specific reasons for granting the writ asked for in this case:

1. The holding of the Court below conflicts with the applicable decisions of this Court, which hold that community of interest involves mutual obligations and that one group of stockholders or creditors cannot appropriate all the property of a reorganized company to the exclusion of another group (*Southern Pacific Co.* v. *Bogert*, 250 U. S. 483, 492; *Jackson* v. *Ludeling*, 21 Wall. 616, 622). The doctrine of the two cases just mentioned is particularly applicable here, because it was chiefly the members of the creditors' committee who benefitted from their own breach of trust and wrong.

The landlords in his case were fully justified in believing that the creditors' committee, which purported to represent all creditors, would obey the law and refrain from proposing or submitting to the Court a plan known by it to be unfair or inequitable as against other groups of creditors (*Central Improvement Co.* v. *Cambria Steel*, 210 Fed. 711, affirmed *sub nom. Kansas City Railway* v. *Guardian Trust*, 240 U. S. 166; *Louisville Trust Co.* v. *Louisville, etc., Ry.*, 174 U. S. 674, 686-687). So too were such landlords, when their leases had not been rejected up to the time of the hearing on the reorganization plan and when nothing in the plan made any mention about such unrejected leases not being assumed by the reorganized company, warranted in believing that they were not to be affected and that, therefore, there was no need for them to make an appearance before the Court to oppose the plan. No reported case that we are aware of holds that landlords with unrejected leases, for whom no provision is made in the plan and who are not apprised by the plan that they are to be in any way affected, are bound to subject the plan to a microscopic examination and analysis, so as to be entirely certain

that there does not lurk therein some equivocal language permitting the sponsors of the plan to accomplish an illegal result.

2. The Circuit Court of Appeals has decided an important question of Bankruptcy Law contrary, we think, to the decision of this Court in *Kansas City Railway Co.* v. *Guardian Trust Co.*, 240 U. S. 166.

That case holds that a creditor who assented to a plan of reorganization was not bound by it when the plan did not, on its face, show an intent to prefer the stockholders and leave the unsecured creditors inadequately provided for. In the instant case, the Circuit Court of Appeals has decided that the petitioner was bound by the amended reorganization plan, even though this plan did not disclose on its face that landlords with unrejected leases were not to be provided for and even though the petitioner did not assent thereto. The decision of the Circuit Court of Appeals is also opposed to the *Kansas City* case in that there the creditors affected were permitted to pursue their common law remedies against the property of the insolvent corporation which had been transferred to the reorganized company. In the instant case, the Circuit Court of Appeals refused to vacate the stay which the District Court had granted against all creditors and landlords, enjoining them from suing either the debtor corporation or from following its assets. In that respect the decision of the Circuit Court of Appeals is also squarely opposed to a decision of the same Court in *Howard* v. *Maxwell Motor Car Co., supra.*

3. The Circuit Court of Appeals has decided an important question of law contrary, we think, to the decision of this Court in *Linn Timber Co.* v. *U. S.*, 236 U. S. 574, 577, 578, and contrary also to a decision of the Ninth Circuit Court of Appeals in *Wilson Coal Co.* v. *U. S.*, 188 Fed. 545, 549, which was cited as decisive in *Linn Timber Co.* v. *U. S., supra.* The Circuit Court of Appeals, in the

instant case, following the ruling of the District Court, held that petitioner's motion to re-open the reorganization proceeding should not be granted because, after the consummation of such reorganization, some new capital had been invested in the reorganized company. It so happens, as we have already pointed out, that 50% of the new capital just referred to came from two of the merchandise creditors who were members of the very committee which obtained approval of the reorganization plan now under attack, and the other 50% came from the family and relatives of the former President of the debtor and now Vice-President of the appellee. Thus, the ruling below permits the very parties responsible for the fraud to set up their own investment as a shield against attack. This Court and the Ninth Circuit Court of Appeals, in the two cases cited above, held that a corporation, which has taken over property with knowledge that certain outstanding equities exist in favor of creditors, cannot defend against such creditors by showing that its stockholders subscribed to or purchased their stock in good faith and in ignorance of the claims of the attacking creditors. Furthermore, this Court in *Kansas City Railway* v. *Guardian Trust Co., supra,* permitted creditors, for whom adequate provision had not been made in the reorganization, to proceed against the assets held by the reorganized company, notwithstanding that new money had been invested in that company on the basis of the decree approving the reorganization. And the law on this subject expounded by the State Courts of New York also seems to be opposed to the ruling of the Circuit Court of Appeals below. (See *Hurd* v. *N. Y. & C. Steam Laundry Co.*, 167 N. Y. 89; *Wilson* v. *Aeolian Co.*, 64 App. Div. 337, affirmed 170 N. Y. 618.)

4. If the decision of the Circuit Court of Appeals is allowed to stand, the manifest requirements of Section 77-B (f) (1) (now Section 221 [2]) that a plan shall not

be confirmed unless it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, will be rendered completely ineffectual. What the Circuit Court of Appeals did in this case was to condone a plan which was admittedly unfair to landlords merely because the parties who sponsored it were not caught before the plan was consummated and because these parties either invested or induced others to invest new capital in the reorganized corporation.

Unless the decision of the Circuit Court of Appeals herein is reversed, the device which was successfully employed in this case by the creditors committee will become an authoritative precedent for future plans of the same sort. Not only will this precedent serve to make possible the consummation of reorganization plans which violate the plain intendment of the statute, but it will also place a premium upon sharp dealing on the part of debtors or committees and upon the dispatch with which unfair, inequitable and illegal plans are railroaded through by sponsors who are in control at the time. If sponsors of plans of reorganization know that the statutory requirements of fairness and non-discrimination will be enforced only when the Court or the creditors to be affected are sufficiently alert to discover the unfairness or discrimination attempted by a particular plan before confirmation is had, the temptation to evade the statute would be very great indeed. Such sponsors will know that they have nothing to lose by venturing an illegal plan and that the worst that can happen is that if the illegal features are discovered, the plan will be disapproved and amended. On the other hand, if these sponsors know that a plan which fails to comply with statutory requirements for equality of treatment and which accomplishes a wrong forbidden by the statute will not stand, even though confirmation is obtained through the failure of the Court or others affected to detect the illegality intended, and even though new capital may be brought into the business,

then we may be certain that attempts to railroad through an illegal plan such as was done in this case will be abandoned.

5. One of the issues raised by the decision of the Circuit Court of Appeals presents an important question of Federal Law, which as yet has not been authoritatively settled by this Court. That question is whether a landlord with an unrejected lease can be effectively barred from participating in the reorganization through the mere failure to provide for him in the reorganization plan. In an article written by Professor Douglas (now Mr. Justice Douglas of this Court) in collaboration with Mr. Jerome N. Frank, the present Chairman of the Securities and Exchange Commission, in 42 Yale Law Journal 1003, the following terse and succinct statement of the law is made (p. 1009):

> "The assumption that he can be effectively barred through reorganization plans by mere failure to provide for him cannot be sustained. If the reorganization managers do not extend to him the same protection as is extended to other creditors, they proceed at the risk of the new corporation being liable to the landlord as, if and when his claim matures and become liquidated. This result is obvious if the landlord has a claim which is provable in bankruptcy or receivership. It is equally true though the landlord has no claim satisfying the standard tests of provability, for he is entitled to participation under such reorganization plan despite the fact that at the time of the consummation of the plan by a sale of the assets to a new company his claim is wholly contingent."

The conclusion reached in the article just cited is not only in accord with the statutory requirement of Section 77-B and the present Chapter X of the Bankruptcy Act, but also reflects the judicial conception of fairness and non-discrimination in a reorganization as enunciated in a long line of authorities, many of which have been cited in this petition.

6. The holding of the Circuit Court of Appeals below that the very plan of reorganization in the instant case contained notice of rejection or operated as a rejection of the petitioner's lease and thus conferred upon petitioner the status of a creditor, entitling it to be heard in opposition to the plan, is contrary to the decision of the Circuit Court of Appeals for the Fourth Circuit in *Consolidated Gas Elec. L. & P. Co.* v. *United Rys. & Elec. Co.*, 85 Fed. (2nd) 799, cert. den. 57 Sup. Ct. 493. In that case, the Fourth Circuit Court of Appeals held that if an executory contract is to be rejected on behalf of a debtor in a reorganization proceeding, it must be done in a manner and at a time to give the other contracting party the status of an unsecured creditor and also that the right of rejection must be exercised in the plan or before the plan is confirmed. In the instant case, manifestly, the right of rejection was not exercised in the plan or prior thereto. An attempt was made to reserve such right of rejection for the reorganized company, to be exercised after the reorganization and at a time when the petitioner could not assert a claim or be heard in opposition to the plan.

7. The holding of the Circuit Court of Appeals below was that petitioner's application to reopen the reorganization proceeding or for other relief, such as pursuing the assets of the debtor corporation in the hands of the reorganized company, should be barred because no actual fraud was shown. This is not only erroneous, but conflicts with the applicable decisions of this Court (*Southern Pacific Co.* v. *Bogert, supra; Jackson* v. *Ludeling, supra; Central Improvement Co.* v. *Cambria Steel Co.*, affirmed *sub nom. Kansas City Railway* v. *Guardian Trust Co., supra; Howard* v. *Maxwell Motor Co., supra*).

The cases just cited establish that it is a fraud as a matter of *law* for a reorganization plan to fail to make equal provision for creditors on the same footing. Admittedly, the reorganization plan in the instant case not

only failed to make equal provision for the merchandise and the landlord creditors, but made no provision whatever for the landlord creditors with the unrejected leases and brazenly provided that all of the assets *in toto* were to go to the merchandise creditors, who alone were to receive the stock of the reorganized company. In *Northern Pacific Co.* v. *Boyd,* 228 U. S. 482, this Court, in allowing the plaintiff to pursue his common law rights against the assets which were transferred to the reorganized company, said that if actual fraud had to be shown before equitable relief could be given, then the creditors' legal rights would depend upon the motive with which organizers act and the method by which they carry out their scheme. In that case, this Court held that although the reorganization plan was "free from any moral or actual fraud" (p. 502), a contingent creditor, for whom no provision had been made, was nevertheless entitled to subject the interest which stockholders had obtained to the payment of their claims. And in the case of *Howard* v. *Maxwell Motor Co., supra,* as we have already pointed out, the Second Circuit Court of Appeals also permitted the landlord, who had not been provided for in the reorganization, to follow the assets held by the reorganized company, in spite of the fact that it found no actual fraud. And in the later case of *In re Alamac Operating Corp.,* 42 Fed. (2) 120, the same Court again ruled that the State of New York, whose claims had not been provided for in the equity receivership reorganization, was not bound by such reorganization and was therefore entitled to assert its claim against the new reorganized company and its assets. In the instant case, as we have mentioned, not only did the District Court and the Circuit Court of Appeals decline to allow a reopening of the reorganization, but even declined to accord petitioner the right to pursue his common law remedies against the assets held by the reorganized company.

In the cases of *Southern Pacific Co.* v. *Bogert* (at page 492), and in *Jackson* v. *Ludeling* (at page 634, *supra*), this Court pointed out that the fraud involved was outside the record and that the forms of law were scrupulously observed, but that the wrong lay in refusing to make *pro rata* distribution of the corporate assets upon equal terms to those entitled to it, for which reason the reorganization plans could not stand against those who were wronged thereby.

We submit that the decision of the Circuit Court of Appeals in the instant case circumscribing and limiting its own power to redress the wrong to the petitioner because of the absence of what it calls actual fraud, is not only erroneous, but wholly undesirable from every standpoint.

Conclusion.

It is respectfully submitted that this petition for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit should be granted.

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